



What we see across the technology value chain

April 27, 2020

*“Bad companies are destroyed by crisis.
Good companies survive them.
Great companies are improved by them. “*
Andy Grove, Co-founder of Intel and tech visionary

Since the lock down on March 23, the team at Herald has participated in over 150 virtual meetings and webcasts with companies. We are also in the midst of the Q1 earnings season so we are getting lots of daily updates from companies in our portfolios and others in the sector. The following are some common trends we are seeing from our interactions:

- 1) Demand for most products related to datacentre infrastructure is strong. Automotive and Industrial demand are highlighted as weak.
- 2) There has been a short-term upturn in demand for hardware and services to facilitate homeworking- including laptops, routers, virtual PCs. There is a concern about the “pull forward” and the sustainability of this demand.
- 3) Many companies are reorienting sales efforts and focusing on opportunities to sell to existing customers. This obviously benefits companies with recurring revenues and a large strong installed base of customers compared to those with churn and/or whose business depends on winning new clients. The high element of recurring revenues in many companies in TMT provides relative resilience.
- 4) Different companies have different issues in their supply chains. Most seem to say China is near fully operational.
- 5) Companies are trying to assess where there is true end-market demand and where companies are replenishing inventories for risk management. Despite all the information systems deployed by leading companies, it is still difficult to distinguish between true incremental end-market demand and “double ordering.” Companies with strong balance sheets and whose products have long lives are better positioned for the uncertainty.
- 6) Companies are preserving working capital by taking longer to pay suppliers where they can. This is impacting working capital and cashflows across the chain.



- 7) Software/SaaS companies are showing some flexibility on recurring revenues and allowing customers more leeway such as trying new features without charging them. This benefits incumbent vendors with larger market shares and solid balance sheets compared to fledgling start-ups.
- 8) Companies recognise the uncertainty ahead and most are refraining from giving guidance on full year revenues and profits.
- 9) Advertising revenues will be particularly challenged in a lockdown world. There was a sharp fall in on-line advertising spend from mid-March. Some of the spend has been reoriented from a transactional focus towards brand awareness (e.g. autos).
- 10) There may well be a relative rerating for companies with sound business models, which exist in this portfolio, because profits in other parts of the market will evaporate, and balance sheets will be challenged in other sectors. Nevertheless, overall, we still expect profits downgrades in the technology sector.

The following are some representative comments during the last two weeks from companies in our portfolio and others in the sector.

Comments*:

Operations and Supply Chain

“With 95% of our employees currently working from home, all of SAP is as close to a virtual organization as it can get, and we continue to run at nearly 100%.” (SAP)

“Our capabilities are still limited compared to normal operation, but as the pandemic has impacted different parts of the world at different times and to different degrees, we and our supply chain partners are successfully leveraging our global footprint to support our customers' most critical priorities. Past investments we have made to complement US production capability with operations in Korea and Taiwan have proven valuable as both of those countries have reported earlier stabilization of local COVID-19 conditions.” (Lam Research, supplier to TSMC, Samsung Electronics, Intel and Micron)

“Shortly after our January call, we started to see the impacts of COVID-19 in China ...Partners have now returned to work and production is increasing every week. ...Our factories remain operational and in Q1, we are able to mitigate most of the COVID-19 related supply chain disruptions and fulfil all of our customers' committed client CPU orders as expected.” (Intel)



“The equipment industry is currently supply constrained. We exited the March quarter with record backlog and would expect to fulfil this unmet demand over the coming months.” *(Lam Research, supplier to TSMC, Samsung Electronics, Intel, and Micron)*

“At this time, the vast majority of our global employee base is working from home. And that transition has gone very smoothly. From the business continuity perspective, our infrastructure collaboration platforms and tight communication have enabled us to maintain a high level of productivity, and our R&D innovation projects and customer deliverables continue to track well. Our sales and application engineering teams have also adapted well with this new work model” *(Cadence)*

“We anticipate that all our manufacturing sites will continue to be operational. However, some of them will run at reduced capacity” *(ST Micro, supplier to Apple)*

“Freight and logistics are more expensive right now. It's up a decent amount in certain areas.” *(Lam Research, supplier to TSMC, Samsung Electronics, Intel, and Micron)*

Demand, Inventories and Backlog

“Nowhere is growth accelerating more than in our cloud and networking businesses ...Through this crisis, the world's cloud and network infrastructure has delivered massive scaling to support vital workloads for businesses and consumers. Cloud-delivered application seen as convenience a quarter ago, such as online shopping and video collaborations have now become indispensable.” *(Intel)*

“We started seeing COVID-19 demand related impact midway through the quarter with weakness in our automotive, broadcast, and consumer business. The weakness was more pronounced in the automotive business as car sales in China and around the globe declined significantly.” *(Xilinx)*

“We've seen no demand disruption, no change in demand.” *(Lam Research, supplier to TSMC, Samsung Electronics, Intel and Micron)*

“The backlog, ... is very different depending on markets. automotive ...forecasts are meaningfully ...down . But on the other hand, Aerospace and Defence, it's really unaffected. ...so video streaming which was hot before the pandemic, it's -- that's clearly going to go an increase. I think also on communications infrastructure, again, we'll have to see how that plays out, but it's just going to be a lot more traffic.” *(Xilinx)*

“Our view for the full year, our modelling is for the automotive to be down between 25% to 15% in terms of car production, ...we do believe at the end that Q2 is going to be the most difficult quarter. And from Q3 and Q4 to see a recovery in the automotive.” *(ST Micro)*

“We see near-term weakness across the board, especially in the area of discretionary spending.... we see increased interest from our clients in cloud virtualization, workforce transformation and cost reduction programs.” *(Infosys, one of the largest IT services firms globally)*



“During the quarter, we had around 20% demand increase in our technical services, driven by customers scaling up their infrastructure in preparation for increased network demand. Customers accelerating the completion of projects in light of the circumstances as well as the implementation and scaling of remote access VPN, something we've been doing for many years.” *(Checkpoint)*

“Let me talk about the network a little bit, and we have been reporting every week the development of our network since the outbreak of the pandemic. And you have seen some staggering numbers, like 200% up on gaming, 10x up on collaboration tools, 40% up on video. 800 million calls a day, which is twice the amount of what we have on Mother's Day, which is one of the biggest days in the year.” *(Verizon)*

Liquidity and Expense Management

“We acted swiftly and strengthened liquidity. In addition to suspending repurchases, we issued \$10.3 billion in debt in the quarter. Our total cash investment balance at quarter end was \$20.8 billion. ...The company has an exceptional balance sheet and strong cash flow to handle a very wide range of scenarios.” *(Intel)*

“To ensure our financial flexibility, we have initiated prudent measures such as a slowing of hiring and the reduction in discretionary spending. I can assure you that we will continue to balance this disciplined expense management with the continued bold investment in innovation where required to maintain and enhance our competitive advantages.” *(SAP)*

Summary

Although the economic outlook is challenging, we remain optimistic about the long-term outlook for the technology sector.

We are fortunate, as none of the companies in the Herald Worldwide Technology Fund are struggling with liquidity problems and therefore their managements can focus on addressing operational efficiency issues.

Some of the best positioned companies in our portfolio are ones which have navigated prior crises successfully. We are focused on finding more companies whose businesses strengthen as a result of this crisis, but are cognizant of the unprecedented economic uncertainty ahead of us and so intend to remain prudent and invest conservatively.

We will keep you updated as the earnings season progresses and we get more clarity on the outlook.

*(*All quoted comments are from the transcripts of earnings calls of the relevant companies during April 2020)*



Important Information

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